

Message Text

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USEEC ALSO FOR EMBASSY
USOECD ALSO FOR EMBASSY

PASS LABOR, TREASURY, FRB

E.O. 11652: GDS
TAGS: PGOV, PINT, ELAB, UK
SUBJECT: THE END OF INCOMES POLICY AND THE CALLAGHAN
GOVERNMENT

REF: A) LONDON 11117; B) LONDON 11237; C) LONDON 11591

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SUMMARY - RETURNING TO THE ANALYTICAL FRAMEWORK DESCRIBED
IN REF A, IT IS EVIDENT THAT THE ABSENCE OF A THIRD YEAR
OF VOLUNTARY PAY RESTRAINT (REF B) WILL HAVE A DESTABIL-
IZING EFFECT ON THE CALLAGHAN GOVERNMENT. WHILE THE
TERMS OF THE TRANSITION FROM THE PHASE II VOLUNTARY PAY
RESTRAINT TO A LESS CONSTRAINED COLLECTIVE BARGAINING
SITUATION HAVE YET TO BE DETERMINED -- AND THEY WILL BE

OF PIVOTAL IMPORTANCE -- IT IS ALREADY POSSIBLE TO IDENTIFY THE VARIABLES UPON WHICH THE TRANSITION WILL IMPACT MOST HEAVILY AND TO DISCERN POTENTIAL PROBLEM AREAS. EVEN THOUGH THE ECONOMIC MODEL (REF C) INDICATES THAT A MASSIVE "WAGES EXPLOSION" IS UNLIKELY, RECENT DEVELOPMENTS SEEM TO THREATEN THE LIBERAL PACT AND LABOR PARTY COHESION. THE CHANCES THAT RELATIONS BETWEEN THE GOVERNMENT AND THE TUC WILL DETERIORATE ARE ALSO INCREASED. THE EXTENT TO WHICH THESE TENDENCIES WILL AFFECT THE PROGRESS OF "POLITICAL ROT" AND THE GOVERNMENT'S PROPENSITY FOR POLITICAL MISCALCULATION, AS YET, IS PROBLEMATICAL. THE GOVERNMENT'S POLITICAL VULNERABILITY, HOWEVER, MUST BE JUDGED TO HAVE INCREASED, ALTHOUGH AN EARLY ELECTION IS NOT YET A PROBABILITY.

END SUMMARY.

1. RECENT EVENTS HAVE ENDED HOPES FOR A THIRD YEAR OF VOLUNTARY PAY RESTRAINT ON THE PART OF THE UNIONS (REF B). THE NATURE OF THE TRANSITION FROM THE SECOND YEAR OF PAY RESTRAINT TO A LESS CONSTRAINED COLLECTIVE BARGAINING SITUATION WILL BE OF CENTRAL IMPORTANCE TO THE CALLAGHAN GOVERNMENT, AS WELL AS TO THE BRITISH ECONOMY. THE GOVERNMENT HAS NOT YET DETERMINED ITS POLICIES IN THE ABSENCE OF A PHASE III ACCORD; INDEED THERE IS CURRENTLY NO CONSENSUS IN THE CABINET AS TO HOW IT SHOULD PROCEED (SEPTEL). THE VARIOUS POLITICAL

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REACTIONS TO AN AS YET UNDEFINED GOVERNMENT POLICY, OF COURSE, CANNOT BE PREDICTED. EVEN THOUGH THE SHAPE OF THE TRANSITION PHASE IS NOT YET DISCERNABLE, THERE IS LITTLE DOUBT THAT RECENT DEVELOPMENTS AND THEIR CONSEQUENCES WILL IMPACT ADVERSELY ON THE CALLAGHAN GOVERNMENT, INCREASING INTERNAL AND EXTERNAL PRESSURES ON IT.

2. REF A DESCRIBED AN ANALYTICAL FRAMEWORK FOR ASSESSING THE CALLAGHAN GOVERNMENT'S POLITICAL PROSPECTS. IDENTIFYING SIX CRITICAL AND INTERRELATED VARIABLES -- COHESION OF THE LABOR PARTY; DURABILITY OF THE LIBERAL PACT; PROGRESS OF POLITICAL ROT WITHIN THE GOVERNMENT; THE POSSIBILITY OF POLITICAL MISCALCULATION; THE NATURE OF GOVERNMENT RELATIONS WITH THE TUC; AND THE STATE OF THE ECONOMY. THIS CABLE WILL EXAMINE THE WAYS IN WHICH THE FAILURE TO ACHIEVE A STAGE III PAY AGREEMENT MAY AFFECT THESE VARIABLES.

3. THE ECONOMIC MODEL DESCRIBED IN REF C SUGGESTS THAT A LARGE-SCALE "WAGES EXPLOSION" IS UNLIKELY TO RESULT FROM THE RETURN TO "FREE" COLLECTIVE BARGAINING. HOWEVER, AT LEAST SOME EXCESSIVE PAY

CLAIMS AND RELATED INDUSTRIAL ACTION CAN BE EXPECTED AND
THESE WOULD HAVE AN EFFECT ON THE RATE OF INFLATION.
UNEMPLOYMENT, INVESTMENT, AND PRODUCTION. UNDER THE BEST
OF CIRCUMSTANCES, SUCH DEVELOPMENTS COULD HARDLY HELP
CALLAGHAN ATTAIN THE LEVEL OF ECONOMIC RECOVERY HE WOULD

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SEEM TO NEED TO REALIZE HIS LONGER-TERM POLITICAL GOAL
-- THE REELECTION OF A LABOR GOVERNMENT. THESE FACTORS
WILL ALSO IMPINGE DIRECTLY ON THE OTHER KEY POLITICAL
VARIABLES. THUS THE FAILURE TO GAIN A THIRD YEAR OF
VOLUNTARY PAY RESTRAINT FROM THE UNIONS MUST BE CON-
SIDERED A SETBACK IN BOTH SHORT- AND LONG-RANGE TERMS,
EVEN THOUGH THE ECONOMIC LIMITS OF THE REVERSE REMAIN
UNDEFINED.

4. WE CANNOT YET PREDICT HOW THE ABSENCE OF A PHASE III

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AGREEMENT WILL INFLUENCE THE GOVERNMENT/TUC RELATIONSHIP. IF THE TRANSITION SHOULD TURN OUT TO BE ORDERLY AND SERIOUS CONFRONTATION AVOIDED, THE SHORT-TERM RELATIONSHIP COULD BE STRENGTHENED. THE RETURN TO A LESS CONSTRAINED BARGAINING SITUATION COULD REVERSE CURRENT ATTITUDES AMONG UNION VOTERS WHICH ARE FAVORABLE TO THE CONSERVATIVES, AS NEW SETTLEMENTS CAN BE EXPECTED TO BEGIN TO RESTORE DIFFERENTIALS AND ELIMINATE OTHER ANOMOLIES WHICH OCCURRED UNDER PHASES I AND II. OTHER FACTORS, HOWEVER, ARE AT PLAY. IF THE GOVERNMENT TAKES A TOUGH LINE ON PAY INCREASES FOR PUBLIC EMPLOYEES (ABOUT 40 PERCENT OF THE WORK FORCE), TRYING TO HOLD THEM AT ABOUT 5 PERCENT, AND TRIES TO KEEP THE LID ON PRIVATE AND PUBLIC SECTOR WAGE SETTLEMENTS BY HOLDING MONETARY GROWTH IN LINE WITH ITS IMF COMMITMENTS. RELATIONS BETWEEN THE GOVERNMENT AND PUBLIC SECTOR UNIONS COULD DETERIORATE SHARPLY. THE TUC COULD WELL BE DRAWN INTO ANY SUCH CONFLICT. IF ACCCOMPANIED BY WIDESPREAD STRIKES IN THE PRIVATE SECTOR, THE RELATIONSHIP COULD BREAK DOWN. CONFRONTATION COULD ALSO OCCUR IF THE GOVERNMENT SEEKS TO IMPOSE A RIGID WAGES POLICY BY STATUTE OR OTHER MEANS.

5. THE FAILURE OF THE GOVERNMENT AND THE TUC TO REACH A PHASE III ACCORD HAS ALREADY INCREASED THE STRESS BETWEEN THE LIBERALS AND THE GOVERNMENT. LIBERAL ECONOMIC SPOKESMAN JOHN PARDOE HAS PUBLICLY REAFFIRMED THE LIBERAL DEMAND FOR A STATUTORY PAY POLICY -- THE LIBERALS APPARENTLY FAVOR A FORM OF PRICE CONTROL WHICH WOULD PREVENT INDUSTRY FROM PASSING ON EXCESSIVE WAGE INCREASES IN THE FORM OF HIGHER PRICES, COUPLED WITH A TAX STRUCTURE THAT WOULD "CLAW BACK" EXCESSIVE WAGE GAINS FROM WORKERS. ALTHOUGH PARDOE'S STATEMENT MAY ACCU-

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RARELY REFLECT THE THEORETICAL LIBERAL POSITION, IT APPEARS UNLEAVENED BY HIS COLLEAGUES' INSTINCT FOR POLITICAL SURVIVAL AND WOULD PROBABLY BE POLITICALLY FATAL FOR THE GOVERNMENT. UNLESS WAGE CLAIMS WON BETWEEN AUGUST (WHEN SETTLEMENTS WILL NO LONGER BE MADE UNDER PHASE II) AND NOVEMBER (WHEN THE GOVERNMENT/LIBERAL PACT IS DUE FOR RENEWAL) ARE CLEARLY EXCESSIVE, WE ARE INCLINED TO BELIEVE THE LIBERAL INSTINCT FOR SURVIVAL WILL PREVAIL AND THE PACT RENEWED. THE ABSENCE OF A

PHASE III AGREEMENT, HOWEVER, MEANS THAT ANY NEW PACT
WILL BE FRAGILE.

6. THE ABSENCE OF PHASE III AGREEMENT, AT ONE LEVEL,
SHOULD DAMPEN INTERNAL STRESS WITHIN THE PLP. THE
DIMINUTION OF CURRENT PAY ANOMOLIES THROUGH NEWLY-
NEGOTIATED WAGE SETTLEMENTS WILL REMOVE AN IMPORTANT
SOURCE OF IRRITATION. BUT THIS BENEFICIAL POLITICAL
EFFECT MAY BE MORE THAN OFFSET BY TIGHT CONTROLS ON
PUBLIC SECTOR WAGES, WHILE HIGHER RATE OF INFLATION
AND GROWING UNEMPLOYMENT RESULTING FROM EXCESSIVE WAGE

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SETTLEMENTS WOULD ALSO ACCENTUATE INTERNAL DIVISION
WITHIN THE PLP. THUS RELATIVELY LARGE PAY CLAIMS ARE

LIKELY TO REDUCE PLP COHESION, PARTICULARLY ON ECONOMIC ISSUES. ANY DETERIORATION IN THE GOVERNMENT'S RELATIONSHIP WITH THE TUC WOULD ALSO WEAKEN THIS COHESION. WHILE THE FINAL BALANCE WILL DEPEND ON THE WAY THE TRANSITION WORKS OUT IN PRACTICE, THERE IS NO DOUBT THAT THE ABSENCE OF A PHASE III AGREEMENT IS POTENTIALLY DAMAGING TO PLP COHESION.

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7. IT IS NOT YET CLEAR HOW THE TRANSITION WILL IMPINGE ON THE "POLITICAL ROT" AND POLITICAL MISJUDGMENT FACTORS. ARGUABLY, A SMOOTH TRANSITION TO UNRESTRAINED COLLECTIVE BARGAINING WOULD REDUCE THE DANGER FROM BOTH FACTORS, BUT IT WOULD BE OVERLY SANGUINE TO ASSUME REENTRY WILL BE EASY. IF THE OPPOSITE ASSUMPTION IS MADE, PRESSURES ON THE GOVERNMENT ARE LIKELY TO INCREASE, PROBABLY INTENSIFYING THE SPREAD OF POLITICAL ROT AND THE GOVERNMENT'S PROPENSITY FOR POLITICAL MISCALCULATION.

8. OUR TENTATIVE ANALYSIS CLEARLY INDICATES THAT THE TUC'S INABILITY TO DELIVER ON A PHASE III AGREEMENT WILL PROBABLY IMPACT ADVERSELY ON AT LEAST FOUR OF THE SIX KEY VARIABLES WHICH WILL DETERMINE THE CALLAGHAN GOVERNMENT'S CAPACITY TO REMAIN IN POWER. ALTHOUGH WE CAN DO LITTLE MORE AT THIS POINT THAN IDENTIFY THOSE VARIABLES WHICH WILL BE MOST DIRECTLY AFFECTED, INDICATIONS ARE THAT CALLAGHAN'S POSITION, DESPITE HIS APPARENT PARLIAMENTARY ADVANTAGE, WILL BECOME MORE VULNERABLE. IT IS STILL PREMATURE TO PREDICT AN EARLY GENERAL ELECTION, BUT THAT POSSIBILITY IS DEFINITELY GREATER THAN IT WAS A FEW WEEKS AGO.

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